Description of the Carried Interest Fairness Act of 2012,
a Bill to Provide for the Tax Treatment of
Personal Service Income Earned in Pass-thru Entities

1. Income of partners for performing investment management services treated as ordinary income received for performance of services (secs. 83, 710, 751, 856, 1402, 6662, 6662A, 6664, and 7704 of the Code)

Present Law

Partnership profits interest for services

A profits interest in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate liquidation of the partnership. The treatment of the receipt of a profits interest in a partnership (sometimes referred to as a carried interest) in exchange for the performance of services has been the subject of controversy. Though courts have differed, in some instances, a taxpayer receiving a profits interest for performing services has not been taxed upon the receipt of the partnership interest.[1]

In 1993, the Internal Revenue Service, referring to the litigation of the tax treatment of receiving a partnership profits interest and the results in the cases, issued administrative guidance that the IRS generally would treat the receipt of a partnership profit interest for services as not a taxable event for the partnership or the partner.[2] Under this guidance, this treatment does not apply, however, if: (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a publicly traded partnership. More recent administrative guidance[3] clarifies that this treatment applies provided the service partner takes into income his distributive share of partnership income, and the partnership does not deduct any amount either on grant or on vesting of the profits interest.[4]

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[1] Only a handful of cases have addressed this issue. Though one case required the value to be included currently, where value was easily determined by a sale of the profits interest soon after receipt (*Diamond v. Commissioner*, 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974)), a more recent case concluded that partnership profits interests were not includable on receipt, because the profits interests were speculative and without fair market value (*Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991)).

[2] Rev. Proc. 93-27 (1993-2 C.B. 343) citing the *Diamond* and *Campbell* cases, *supra*.

[3] Rev. Proc. 2001-43 (2001-2 C.B. 191). This result applies under the guidance even if the interest is substantially nonvested on the date of grant.

[4] A similar result would occur under the "safe harbor" election under proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest. REG-105346-03, 70 Fed. Reg. 29675 (May 24, 2005).

By contrast, a partnership capital interest received for services is includable in the partner's income under generally applicable rules relating to the receipt of property for the performance of services.[5] A partnership capital interest for this purpose is an interest that would entitle the receiving partner to a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in liquidation.[6]

Property received for services under section 83

In general

Section 83 governs the amount and timing of income and deductions attributable to transfers of property in connection with the performance of services. If property is transferred in connection with the performance of services, the person performing the services (the "service provider") generally must recognize income for the taxable year in which the property is first substantially vested (i.e., transferable or not subject to a substantial risk of forfeiture). The amount includible in the service provider's income is the excess of the fair market value of the property over the amount (if any) paid for the property. A deduction is allowed to the person for whom such services are performed (the "service recipient") equal to the amount included in gross income by the service provider.[7] The deduction is allowed for the taxable year of the service recipient in which or with which ends the taxable year in which the amount is included in the service provider's income.

Property that is subject to a substantial risk of forfeiture and that is not transferable is generally referred to as "substantially nonvested." Property is subject to a substantial risk of forfeiture if the individual's right to the property is conditioned on the future performance (or refraining from performance) of substantial services. In addition, a substantial risk of forfeiture exists if the right to the property is subject to a condition other than the performance of services, provided that the condition relates to a purpose of the transfer and there is a substantial possibility that the property will be forfeited if the condition does not occur.

Section 83(b) election

Under section 83(b), even if the property is substantially nonvested at the time of transfer, the service provider may nevertheless elect within 30 days of the transfer to recognize income for the taxable year of the transfer. Such an election is referred to as a "section 83(b) election." The service provider makes an election by filing with the IRS a written statement that includes the fair market value of the property at the time of transfer and the amount (if any) paid for the property. The service provider must also provide a copy of the statement to the service recipient.

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[5] Secs. 61 and 83; Treas. Reg. sec. 1.721-1(b)(1); *see U.S. v. Frazell*, 335 F.2d 487 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965).

[6] Rev. Proc. 93-27, 1993-2 C.B. 343.

[7] Sec. 83(h).

Proposed regulations on compensatory transfer of a partnership interest

The Department of Treasury has issued proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest.[8] The proposed regulations provide that a partnership interest is "property" for purposes of section 83. Thus, a compensatory transfer of a partnership interest is includible in the service provider's gross income at the time that it first becomes substantially vested (or, in the case of a substantially nonvested partnership interest, at the time of grant if a section 83(b) election is made).

However, because the fair market value of a compensatory partnership interest is often difficult to determine, the proposed regulations also permit a partnership and a partner to elect a safe harbor under which the fair market value of a compensatory partnership interest is treated as being equal to the liquidation value of that interest. Therefore, in the case of a true profits interest in a partnership (one under which the partner would be entitled to nothing if the partnership were liquidated immediately following the grant), under the proposed regulations, the grant of a substantially vested profits interest (or, if a section 83(b) election is made, the grant of a substantially nonvested profits interest) results in no income inclusion under section 83 because the fair market value of the property received by the service provider is zero. The proposed safe harbor is subject to a number of conditions. For example, the election cannot be made retroactively and must apply to all compensatory partnership transfers that occur during the period that the election is in effect.

Passthrough tax treatment of partnerships

The character of partnership items passes through to the partners, as if the items were realized directly by the partners.[9] Thus, for example, long-term capital gain of the partnership is treated as long-term capital gain in the hands of the partners.

A partner holding a partnership interest includes in income its distributive share (whether or not actually distributed) of partnership items of income and gain, including capital gain eligible for the lower tax rates. A partner's basis in the partnership interest is increased by any amount of gain thus included and is decreased by losses. These basis adjustments prevent double taxation of partnership income to the partner, preserving the partnership's tax status as a passthrough entity. Money distributed to the partner by the partnership is taxed to the extent the amount exceeds the partner's basis in the partnership interest.

Employment tax treatment of partners

In general

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal

[8] 70 Fed. Reg. 29675 (May 24, 2005).

[9] Sec. 702.

Insurance Contributions Act ("FICA").[10] A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act ("SECA").[11]

The FICA tax has two components. Under the old-age, survivors, and disability insurance component ("OASDI"), the rate of tax is 12.4 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee.[12] The amount of wages subject to this component is capped at $110,100 for 2012.[13] Under the hospital insurance ("HI") component, the rate is 2.9 percent, also split equally between the employer and the employee. The amount of wages subject to the HI component of the tax is not capped. The wages of individuals employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax.[14]

The SECA tax rate is the combined employer and employee rate for FICA taxes. Under the OASDI component, the rate of tax is 12.4 percent and the amount of earnings subject to this component is capped at $110,100 for 2012. Under the HI component, the rate is 2.9 percent, and the amount of self-employment income subject to the HI component is not capped.

For SECA tax purposes, net earnings from self-employment means the gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the self-employment tax rules.[15] Specified types of income or loss are excluded, such as rentals from real estate in certain

[10] See Chapter 21 of the Code.

[11] Sec. 1401.

[12] Secs. 3101 and 3111.

[13] A temporary reduction, expiring February 29, 2012, provides (1) applies a reduced OASDI tax rate of 4.2 percent for employees to wages received through February 29, 2012, and applies to employees an additional two-percent tax on wages received during January 1, 2012, to February 29, 2012, in excess of $18,350; and (2) applies a reduced OASDI tax rate of 10.4 percent for self-employed individuals through 2012 (with a related adjustment to the deduction for one-half of SECA tax), and limits the self-employment income eligible for the reduced rate to $18,350. The temporary reduction was enacted in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, through December 31, 2011, and was extended through February 29, 2012, by the Temporary Payroll Tax Cut Continuation Act of 2011, Pub. L. No. 112-78.

[14] S corporation shareholders who are employees of the S corporation are subject to FICA taxes. A considerable body of case law has addressed the issue of whether amounts paid to S corporation shareholder-employees are reasonable compensation for services and therefore are wages subject to FICA tax or are properly characterized as another type of income (typically, dividends) and therefore not subject to FICA tax.

[15] For purposes of determining net earnings from self-employment, taxpayers are permitted a deduction from net earnings from self-employment equal to the product of the taxpayer's net earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), i.e., 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically the equivalent of an employee's wages plus the employer share of FICA taxes. The deduction is intended to provide parity between FICA and SECA taxes. In addition, self-employed individuals may deduct one-half of self-employment taxes for income tax purposes under section 164(f).

circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.

For an individual who is a partner in a partnership, the net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (excluding specified types of income, such as capital gains and dividends, as described above). This rule applies to individuals who are general partners.

A special rule applies for limited partners of a partnership.[16] In determining a limited partner's net earnings from self-employment, an exclusion is provided for his or her distributive share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.

Unearned income Medicare contribution

For taxable years beginning after 2012, in the case of an individual, estate, or trust an unearned income Medicare contribution tax is imposed. In the case of an individual, the tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income[17] over the threshold amount. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

The tax is not deductible in computing any tax imposed by subtitle A of the Internal Revenue Code (relating to income taxes).

Net investment income is investment income reduced by the deductions properly allocable to such income. Investment income is the sum of (i) gross income from interest, dividends, annuities, royalties, and rents (other than income derived from any trade or business to which the tax does not apply), (ii) other gross income derived from any business to which the tax applies, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply.

In the case of a trade or business, the tax applies if the trade or business is a passive activity with respect to the taxpayer or the trade or business consists of trading financial instruments or commodities (as defined in section 475(e)(2)). The tax does not apply to other

[16] Sec. 1402(a)(13).

[17] Modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under section 911(a)(1), net of the deductions and exclusions disallowed with respect to foreign earned income.

trades or businesses conducted by a sole proprietor, partnership, or S corporation. Income, gain, or loss on working capital is not treated as derived from a trade or business.

In the case of the disposition of a partnership interest or stock in an S corporation, gain or loss is taken into account only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition. Thus, only net gain or loss attributable to property held by the entity which is not property attributable to an active trade or business is taken into account.[18]

Net investment income does not include amounts subject to SECA tax. Thus, for example, in the case of a partner, the tax does not apply to any item taken into account in determining self-employment income for the taxable year on which tax is imposed under the self-employment tax rules.

Income tax treatment of publicly traded partnerships

Under present law, a publicly traded partnership generally is treated as a corporation for Federal tax purposes.[19] For this purpose, a publicly traded partnership means any partnership if interests in the partnership are traded on an established securities market, or interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income (sec. 7704(c)(2)). However, this exception does not apply to any partnership that would be described in section 851(a) if it were a domestic corporation, which includes a corporation registered under the Investment Company Act of 1940 as a management company or unit investment trust.

Qualifying income includes interest, dividends, and gains from the disposition of a capital asset (or of property described in section 1231(b)) that is held for the production of income that is qualifying income. Qualifying income also includes rents from real property, gains from the sale or other disposition of real property, and income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). In the case of a partnership, a principal activity of which is the buying and selling of commodities (not described in section 1221(a)(1)) or futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool), qualifying income also includes income and gains from such commodities, futures, options or forward contracts.

The rules generally treating publicly traded partnerships as corporations were enacted in 1987 to address concern about long-term erosion of the corporate tax base. At that time,

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[18] For this purpose, a business of trading financial instruments or commodities is not treated as an active trade or business.

[19] Sec. 7704(a).

Congress stated, "[t]o the extent that activities would otherwise be conducted in corporate form, and earnings would be subject to two levels of tax (at the corporate and shareholder levels), the growth of publicly traded partnerships engaged in such activities tends to jeopardize the corporate tax base."[20] Referring to recent tax law changes affecting corporations, the Congress stated, "[t]hese changes reflect an intent to preserve the corporate level tax. The committee is concerned that the intent of these changes is being circumvented by the growth of publicly traded partnerships that are taking advantage of an unintended opportunity for disincorporation and elective integration of the corporate and shareholder levels of tax."[21]

The 1987 legislation provided a transition rule grandfathering existing partnerships for 10 years. Under the transition rule, in the case of partnerships existing on December 31, 1987, the general rule treating publicly traded partnerships as corporations applies for taxable years beginning after December 31, 1997.[22] A partnership was not treated as an existing partnership for this purpose if a substantial new line of business was added.

Real estate investment trusts (REITs)

A real estate investment trust ("REIT") is an entity that derives most of its income from passive real-estate-related investments. A REIT must satisfy a number of tests on an annual basis that relate to the entity's organizational structure, the source of its income, and the nature of its assets. If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its investors each year generally is treated as a dividend deductible by the REIT and includible in income by its investors. In this manner, the distributed income of the REIT is not taxed at the entity level. The distributed income is taxed only at the investor level. A REIT generally is required to distribute 90 percent of its income (other than net capital gain) to its investors before the end of its taxable year.

For an entity to qualify as a REIT, at least 95 percent of its gross income generally must be derived from certain passive sources (the "95-percent income test"). In addition, at least 75 percent of its income generally must be from certain real estate sources (the "75-percent income test"), including rents from real property (as defined) and gain from the sale or other disposition of real property. Amounts received as impermissible "tenant services income" are not treated as rents from real property.[23] In general, such amounts are for services rendered to tenants that are

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[20] H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1065.

[21] H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1066.

[22] The Taxpayer Relief Act of 1997 (Pub. L. No. 105-34) added section 7704(g), permitting electing 1987 partnerships not to be subject to the general rule treating publicly traded partnerships as corporations and to be subject to an additional tax.

[23] A REIT is not treated as providing services that produce impermissible tenant services income if such services are provided by an independent contractor from whom the REIT does not derive or receive any income. An independent contractor is defined as a person who does not own, directly or indirectly, more than 35 percent of the shares of the REIT. Also, no more than 35 percent of the total shares of stock of an independent contractor (or of the interests in net assets or net profits, if not a corporation) can be owned directly or indirectly by persons owning 35 percent or more of the interests in the REIT.

not “customarily furnished” in connection with the rental of real property. In addition, at least 75 percent of the value of its total assets must be represented by real estate assets, cash and cash items (including receivables), and government securities, and maximum percentages apply to ownership of other types of securities (the “asset test”).

Accuracy-related penalties

An accuracy-related penalty of 20 percent is imposed under section 6662 on the portion of any underpayment of tax attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement.[24] An understatement of income tax is the excess of the amount of tax properly required to be shown on a return over the amount actually shown on the return, subject to certain reductions.[25] An understatement is substantial for a noncorporate taxpayer if the amount of the understatement exceeds the greater of (1) 10 percent of the correct tax liability or (2) $5,000.[26] For corporate taxpayers an understatement is substantial if it exceeds the lesser of (1) 10 percent of the correct tax liability (or $10,000 if greater) or (2) $10,000,000.[27]

Similarly, section 6662A imposes a 20-percent penalty on reportable transaction understatements, that is, understatements involving listed transactions or any reportable transaction (other than a listed transaction) if a significant purpose of the transaction is the avoidance or evasion of Federal income tax.[28] The penalty rate is increased to 30 percent for transactions subject to 6662A which are not adequately disclosed in accordance with section 6011 and the regulations promulgated thereunder.[29]

The section 6662 accuracy-related penalty is not imposed on an underpayment (or portion thereof) if the taxpayer demonstrates a reasonable cause for the underpayment and the taxpayer acted in good faith.[30] The section 6662A reportable transaction understatement penalty is subject to a more stringent reasonable cause exception (commonly referred to as the “strengthened reasonable cause exception”). In addition to demonstrating reasonable cause and good faith, to avoid application of the section 6662A penalty a taxpayer must demonstrate (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section

[24] Sec. 6662. The penalty rate is increased to 40 percent for gross valuation misstatements. Sec. 6662(h).

[25] Sec. 6662(d)(2). An understatement is generally reduced by amounts attributable to (1) positions for which the taxpayer has substantial authority, or (2) items adequately disclosed and for which the taxpayer has a reasonable basis. The reduction does not apply to tax shelter items.

[26] Sec. 6662(d)(1)(A).

[27] Sec. 6662(d)(1)(B).

[28] Sec. 6662A(b)(2).

[29] Sec. 6662A(c).

[30] Sec. 6664(c).

6011, (2) that there is or was substantial authority for such treatment, and (3) reasonable belief that such treatment was more likely than not the proper treatment. A reasonable belief must be based on the facts and law as they exist at the time that the return in question is filed and must relate solely to the taxpayer's chances of success on the merits of the treatment.[31] Moreover, reliance on professional advice may support a taxpayer's reasonable belief only in certain circumstances.[32]

In addition, for transactions entered into after March 30, 2010, a strict liability penalty is imposed under section 6662 for an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance, as defined in section 7701(o), or failing to meet the requirements of any similar rule of law. The penalty rate is 20 percent (increased to 40 percent if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return).

Explanation of Provision

Partnership interests transferred in connection with the performance of services under section 83

In the case of a transfer after the date of enactment of any interest in a partnership in connection with the provision of services to or for the benefit of the partnership, the bill provides for a determination of the fair market value of the partnership interest, and provides that the recipient of the partnership interest is deemed to have made the section 83(b) election unless the recipient affirmatively elects otherwise. Thus, absent such an election, a transferee of a partnership interest for services must include in income for the taxable year of the transfer the fair market value (if any) of the partnership interest.

For purposes of section 83, the fair market value of the partnership interest is generally its liquidation value; that is, specifically, the fair market value is deemed to be the amount the partner would receive if, at the time of transfer of the partnership interest, the partnership had sold all its assets at fair market value and distributed the proceeds (reduced by partnership liabilities) to the partners in liquidation of the partnership.

Recharacterization as ordinary income

The provision generally treats as ordinary income the net capital gain with respect to an investment services partnership interest except to the extent the gain is attributable to the partner's qualified capital interest. The capital gain recharacterized under the provision is taxed at ordinary income rates and is subject to self-employment tax.

To achieve character matching to the extent of gains treated as ordinary, the provision treats net capital loss with respect to the investment services partnership interest as ordinary loss

[31] Sec. 6664(d)(3).

[32] Section 6664(d)(3)(B) does not allow a reasonable belief to be based on a "disqualified opinion" or on an opinion from a "disqualified tax advisor."

subject to a limitation based on the aggregate amount treated as ordinary income with respect the investment services partnership interest for preceding taxable years to which the provision applies. The Treasury Department is directed to exercise its regulatory authority to provide guidance preventing conversion of losses from capital to ordinary through stuffing of loss assets in situations in which investment services partnership interest holders have previously recognized ordinary income recharacterized under the provision.

Any dividend allocated to an investment services partnership interest is not treated as qualified dividend income for purposes of the section 1(h) rule taxing dividends at capital gains rates. In the case of a corporation, no dividends-received deduction is allowed with respect to any dividend allocated to an investment services partnership interest. The exclusion under section 1202 for gain from the sale or exchange of qualified small business stock does not apply to such gain that is allocated with respect to an investment services partnership interest.

Definition of investment services partnership interest

In general

The provision provides that an investment services partnership interest means an interest in an investment partnership that is acquired or held by any person in connection with the conduct by that person (or a related person) of a trade or business primarily involving the performance of certain services with respect to assets held (directly or indirectly) by the investment partnership.

The services are (1) advising as to the advisability of investing in, purchasing, or selling any specified asset, (2) managing, acquiring, or disposing of any specified asset, (3) arranging financing with respect to acquiring specified assets, and (4) any activity in support of any of the foregoing services. Activities in support of these services are intended to include supervising others who perform the services as well as assisting others who perform the services. Such services provided by a partner of a partnership generally are treated as also provided by the partnership.

An interest in an investment partnership is not treated as an investment services partnership interest for any period before the first date on which it is held in connection with a trade or business of providing these services conducted by the acquiror or holder of the interest (or a related person). An interest in an investment partnership does not cease to be an investment services partnership interest merely because the interest is held other than in connection with such a trade or business (for example, if the holder stops performing these services). An interest in an investment partnership is treated as an investment services partnership interest if it is acquired from a related person in whose hands it was an investment services partnership interest.

Investment partnership

An investment partnership is a partnership meeting two criteria at the end of any calendar quarter ending after the date of enactment. First, substantially all the assets of the partnership are specified assets, determined without regard to any section 197 intangible (within the meaning of section 197(d)).[33] Second, more than half of the capital of the partnership is attributable to qualified capital interests that (in the hands of the owners of the interests) constitute property that is not held in connection with a trade or business. Under this second criterion, it is intended that more than half of the investment partnership's capital come, for example, from the after-tax contributions or taxed but undistributed earnings of investors.

Property held in connection with a trade or business is not intended to include property held for the production of income within the meaning of section 212. Property held for the production of income by an individual is property, ordinary and necessary expenses with respect to which are deductible under section 212 by an individual. The bill provides that in the case of a corporation, the determination of whether property is held in connection with a trade or business is determined as if the taxpayer were an individual.

For example, an investment partnership includes a private equity fund, substantially all the assets of which are securities of portfolio companies in which the fund invests, and more than half the capital of which is attributable to qualified capital interests of partners (for example, limited partners) who hold interests in the fund as investors and not in connection with their trade or business.

Under a special rule for determining if property (such as a partnership interest) is not held in connection with a trade or business under this rule, except as otherwise provided in Treasury Department guidance, an election of mark to market for dealers in commodities under section 475(e) and an election of mark to market of traders in securities or commodities is disregarded. Thus, such electing dealers and traders holding property subject to the election may be considered as not holding such property in connection with a trade or business solely for purposes of the definition of an investment partnership. Further, under the special rule, except as otherwise provided in Treasury Department guidance, any investment management-type service of the type described above that is provided by a partner of a partnership is not treated as also provided by the partnership, for purposes of determining whether a partner holds his partnership interest in connection with a trade or business under the definition of an investment partnership.

Antiabuse regulatory authority is provided with respect to the definition of an investment partnership. Convertible or contingent debt or other debt having the attributes of equity can be treated as capital of the partnership for purposes of the definition of an investment partnership under this regulatory authority.

A specific rule applies for purposes of determining whether a partnership interest held by a member of a controlled group of entities constitutes property that is not held in connection with a trade or business. Under this rule, if the partnership interest received in exchange for a contribution to partnership capital by one member would constitute property held in connection with a trade or business, then any interest in the partnership held by any member of the

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[33] Section 197(d) provides that a section 197 intangible means goodwill, going concern value, and any of a list of intangible items. For purposes of determining whether a partnership is an investment partnership, in no event shall any specified asset, including, for example, value attributable to a carried interest, be treated as a section 197 intangible.

controlled group is treated as property held in connection with a trade or business. A controlled group of entities for this purpose means a controlled group of corporations under section 1563(a)(1), except that for this purpose the group can include an insurance company, foreign corporation, other excluded member, or partnership.

For example, suppose Corporation A, a drug developer and manufacturer, enters into a joint venture to develop and manufacture a new drug with unrelated Corporation B, each taking a 50-percent interest in the joint venture partnership. Corporation A's partnership interest is held in connection with A's trade or business of developing and manufacturing drugs, and not for the production of income (by reference to section 212). Members of the controlled group of entities of which Corporation A is a member also are considered to hold any interest in the partnership as property held in connection with a trade or business. Even if, alternatively, Corporation A holds the joint venture interest solely for the production of income, if another member (or members) of the controlled group of which A is a member is engaged in the trade or business of developing and manufacturing drugs, then A is considered to hold its partnership interest in connection with the trade or business of developing and manufacturing drugs.

<u>Specified assets</u>

Under the provision, specified assets means securities (as defined in section 475(c)(2) without regard to the last sentence), real estate held for rental or investment, interests in partnerships, commodities (as defined in section 475(e)(2)), cash or cash equivalents, or options or derivative contracts with respect to such securities, real estate, partnership interests, cash or cash equivalents, or commodities. A security for this purpose means any (1) share of corporate stock, (2) partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust, (3) note, bond, debenture, or other evidence of indebtedness, (4) interest rate, currency, or equity notional principal contract, (5) interest in, or derivative financial instrument in, any such security or any currency (regardless of whether section 1256 applies to the contract), and (6) position that is not such a security and is a hedge with respect to such a security and is clearly identified. A partnership interest includes any partnership interest that is not otherwise treated as a security for purposes of the provision (for example, an interest in a partnership that is not widely held or publicly traded). For example, assume that a private equity fund acquires an interest in an operating business conducted in the form of a non-publicly traded partnership that is not widely held; the partnership interest is a specified asset for purposes of the provision. For purposes of the provision, real estate held for rental or investment does not include, for example, real estate on which the holder operates an active farm. A commodity for this purpose means any (1) commodity that is actively traded, (2) notional principal contract with respect to such a commodity, (3) interest in, or derivative financial instrument in, such a commodity or notional principal contract, or (4) position that is not such a commodity and is a hedge with respect to such a commodity and is clearly identified.

For purposes of this rule, assets held (directly or indirectly) by the partnership are considered to include assets held through any other entity, including a corporation. It is intended that the general rule not be avoided by means of arrangements though which a partner has the right to income or gains based on the performance of assets while taking the position that the partnership does not directly or indirectly hold the assets. Similarly, it is intended that the general rule not be avoided by disposing at capital gains rates (or on a tax-favored basis) of rights to receive income or gains based on the performance of assets. Treasury regulatory authority is provided to implement this intent. For example, such a disposition may be treated as giving rise to ordinary income under Treasury guidance under the provision (described below) relating to a disqualified interest in the form of a derivative instrument with respect to an entity.

<u>Example</u>

The provision does not apply to services other than those giving rise to an investment services partnership interest. For example, assume that a partnership is formed to operate a biotechnology business. Two of the partners are corporations engaged in the biotechnology business that each contribute $1 million worth of biotechnology-related intellectual property that is not a specified asset. The third partner, an individual, contributes his personal services solely as a research scientist. In the following year, the business profits of the partnership are $300,000, and the partnership agreement provides that each of the three partners' distributive share is $100,000. In the following year, the third partner (the research scientist) sells his partnership interest. Because the third partner's services do not consist of the investment management services described above, even if the partnership were an investment partnership, the gain on sale of the partnership interest would not be subject to recharacterization under the provision. As another example, assume instead that a partnership of three individuals is formed to manage investments in specified assets. The first two individuals contribute $1 million each and hold their partnership interests as investors, and the third contributes his personal services advising the partnership as to the advisability of investing in particular specified assets, and managing, acquiring, arranging financing for, and disposing of such assets. The partnership is an investment partnership. In the following year, the profits of the partnership are $300,000, and the partnership agreement provides that each of the three partner's distributive share is $100,000. Because the third partner's services consist of the services described above with respect to specified assets, the third partner's share of profits is subject to recharacterization under the provision. Similarly, if the third partner (the investment manager) later sells his partnership interest and recognizes gain, the gain is subject to recharacterization as ordinary income under the provision.[34]

<u>Exception for qualified capital interest</u>

<u>In general</u>

The provision provides an exception to recharacterization as ordinary income in the case of items of gain, loss, and any dividends that are allocated to the portion of an investment services partnership interest that is a qualified capital interest, provided that allocation requirements are met. In general, the exception to recharacterization for qualified capital interests of service providers is intended to apply to capital invested in the partnership by the service provider if the investment is made on the same terms as investments of capital by partners not providing services.

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[34] The rule providing that gain is treated as ordinary income on the disposition of an investment services partnership interest is described below.

Allocation requirements relating to qualified capital interests

The allocation requirements are met if (1) items are allocated to the service-providing partner's qualified capital interest in the same manner as the items are allocated to other qualified capital interests of partners that do not provide any of the identified investment management services and that are not related to the service-providing partner, and (2) the allocations made to the qualified capital interests of unrelated nonservice providing partners are significant compared to the allocations made to the service-providing partner's qualified capital interest.

Items allocated among the partners in proportion to each partner's qualified capital interest may be considered as allocated in the same manner, under this rule, if the qualified capital interests to which the allocations are made are substantially identical as to the degree of risk and with respect to all other economically significant aspects, benefits and burdens. For example, items are not allocated in the same manner under this rule if they are allocated in the same proportion to economically riskier interests and to less risky interests. Similarly, items are not considered to be allocated in the same manner under this rule if allocations to qualified capital interests of nonservice providing partners are artificially high while returns that are below market, or artificially low, are made to other types of interests (for example, debt) held by the nonservice providing partners.

Example

For example, assume that a partnership that is an investment partnership has several types of interests, one class of which is issued as "units" on the same date at $1 million for each unit. The partnership issues no debt. A partner (that is itself a partnership of individuals who provide services) that will provide investment management services with respect to specified assets of the fund acquires one unit and contributes $1 million to the partnership. The partnership agreement also provides for a carried interest for the service provider equal to 20 percent of profits (subject to a hurdle rate and other conditions). Eleven other partners that are not related to the service partner each acquire nine $1 million units, thereby contributing a total of $99 million. The level and type of risk, rate of return, rights to cash or property distributions during partnership operations and on liquidation, and other economic rights, are identical with respect to each of the 100 units of this class of interests in the partnership. In this situation, the requirements for the exception from recharacterization of the service partner's income from the partnership are met with respect to its unit, because the service partner holds a qualified capital interest of $1 million and allocations are made to the service partner's qualified capital interest in the same manner as to other non-service providing, unrelated partners' qualified capital interests, and the allocations made to such other partners' qualified capital interests are significant compared to the allocations made to the service providing partner's qualified capital interest. Net capital gain allocated to the service provider pursuant to its carried interest (i.e., its right to 20 percent of profits), by contrast, is recharacterized as ordinary income under the general rule of the provision.

Regulatory authority with respect to allocations to qualified capital interests

In addition to regulatory authority to carry out the purposes of the provision in other respects, specific regulatory authority is provided in the context of qualified capital interests to provide exceptions to the allocation requirements.

To the extent provided in Treasury regulations or guidance, the allocation requirements of the provision may be applied separately with respect to a portion of a qualified capital interest. This regulatory authority is intended to apply in situations in which a clearly separable portion of the service provider's qualified capital interest satisfies the allocation requirements, but another portion either does not satisfy the allocation requirements, or it is not clear whether the other portion can satisfy the allocation requirements.

Example

Assume the facts of the foregoing example. After four years, the service partner purchases from the partnership for $3 million a different class of partnership interest (a class B interest) that is not available to nonservice providing partners and that provides for a preferred return. The $3 million contribution increases the service partner's qualified capital interest by $3 million. No other partner has the combination of allocations similar to those held by the service partner, that is, allocations attributable to a partnership unit plus a preferred return on a class B interest. This regulatory authority could appropriately be implemented to provide that the exception from recharacterization applies separately to the portion of the allocations to the partner's qualified capital interest that relate to his unit, but not to the class B interest, because allocations of partnership items are made to the unit portion of the service provider's qualified capital interest in the same manner as such allocations are made to other units held by unrelated partners that do not provide services. It is not, however, consistent with the purposes of the provision for guidance to provide that the preferred return in such a case constitutes a return on a qualified capital interest that is not recharacterized as ordinary, because under the economic arrangements among the partners, the portion of the service provider's qualified capital interest attributable to the class B interest is not invested on the same terms and in the same manner as qualified capital interests of unrelated nonservice providers.

To the extent provided in Treasury regulations or guidance, an exception to the allocation requirements may be provided in cases in which the requirement relating to significance of the allocations to nonservice providers is not met, but it is possible to ensure in guidance that the items are allocated to the qualified capital interests of service providers consistently with the purposes of the general rule. If these conditions are met, then under the regulations or guidance, items of partnership gain, loss, and dividends are not taken into account under the general rule recharacterizing net capital gain as ordinary.

To the extent provided in Treasury regulations or guidance, allocations are not treated as failing to meet the allocation requirements solely because the allocations to the qualified capital interest of the partner holding an investment services partnership interest constitute a lower return on investment than the allocations made to qualified capital interests of unrelated nonservice providing partners. For example, guidance under this authority is appropriate if allocations throughout the term of the partnership are lower to the service providing partner's qualified capital interest than to nonservice providing partners' qualified capital interests. This could arise, for example, because throughout the term of the partnership, nonservice providing partners are allocated a preferred return on their capital to which the service providing partner is not entitled. It is not intended that the guidance treat transitory or temporary lower returns as meeting the allocation requirements if allocations to the service providing partner could reasonably be anticipated to be higher overall, or higher at a future point in the partnership's term. For example, it is not intended that guidance treat the allocation requirements as satisfied if, under the economic arrangements among the partners, initial allocations of income or profit to the service providing partner are lower than to other partners (for example, during the period in which the other partners recoup capital), and then following the satisfaction of conditions (such as return of capital to investor partners, meeting a hurdle rate, the passage of a number of years, or other conditions), the allocations of income or profit to the service providing partner are substantially higher than to other partners. Similarly, it is not intended that guidance treat the allocation requirements as satisfied if the overall allocations of income and gain to the service providing partner are reasonably expected to be higher than to other partners over the life of the partnership or over a substantial period or aspect of partnership activity.

Changes in service and capital contributions

A special rule for determining the qualified capital interest applies in the case of a partnership interest that is not an investment services partnership interest but which becomes one by reason of a change in the services with respect to the assets held (directly or indirectly) by the partnership, or by reason of a change in the capital contributions to the partnership. For example, an individual who is a partner starts to provide the identified investment management services with respect to specified assets of an investment partnership instead of paying an unrelated investment manager to provide the services. In this situation, the qualified capital interest of the partner immediately after the change is not less than the fair market value of the partnership interest (determined immediately before the change).

Tiered partnerships

The provision provides a rule governing allocations to qualified capital interests in the situation of tiered partnerships. Except as otherwise provided in Treasury guidance or regulations, partnership items that are allocated to qualified capital interests in a lower-tier partnership are treated as satisfying the allocation requirements (and thus are not recharacterized as ordinary) when allocated by any upper-tier partnership, provided that (1) at the relevant lower tier, the allocation requirements are met (i.e., the allocations to the service provider's qualified capital interest are made in the same manner that such allocations are made to qualified capital interests of unrelated nonservice providing partners and the allocations to the nonservice providing partners are significant compared to those made to that service provider's qualified capital interest), and (2) the items are allocated on the basis of the partners' qualified capital interests in the relevant upper-tier partnership.

Carry and management fees are not self-charged

Allocations to a service provider's qualified capital interest do not fail to satisfy the allocation requirements solely because they do not reflect the share of the cost of services provided by the service provider with respect to the service provider's own qualified capital interest, except as otherwise provided in Treasury regulations or guidance. This rule is intended to address the situation in which the manager does not charge itself a carry, for example, so that allocations to the manager's qualified capital interest are unreduced by that pro rata portion of the carry whereas allocations to unrelated nonservice providing partners' qualified capital interests are reduced by their pro rata portion of the carry. Similarly, it is intended that the rule address the situation in which the manager does not charge itself a fee with respect to its own qualified capital interest, resulting in a higher income or profit allocation with respect to the manager's qualified capital interest to that extent, because the manager is not allocated the comparable share of the deduction for the fee it charges the partnership, a pro rata portion of the deduction for which is reflected in the allocations to the unrelated nonservice providing partners. It is intended that this rule be applied narrowly.

Example

Assume that a partnership that is a private equity fund has investor partners who commit to contribute $70 million and a manager partner who contributes $30 million in cash. The partnership agreement provides for a 20-percent carried interest for the manager partner, but provides that the manager waives the carry with respect to its own capital contribution of $30 million. After calling all committed capital, the fund invests $100 million. The investor partners' qualified capital interests total $70 million, and the manager's qualified capital interest is $30 million. Assume that other than the waiver of carry, allocations with respect to the manager's qualified capital interest satisfy the requirements of 710(d)(1). After five years, the fund sells an investment and realizes a gain of $20 million. Pursuant to the partnership agreement, the gain is initially allocated to each partner according to invested capital, $14 million to the investor partners in aggregate (that is, $20 million times 70 percent) and $6 million to the manager partner (that is, $20 million times 30 percent). With respect to the investor partners, 80 percent of the initially allocated amount is allocated to them (that is, $11.2 million), a 16 percent return on their qualified capital interests, and the other 20 percent ($2.8 million) is allocated to the manager partner in respect of the carried interest. With respect to the manager's interest, no carried interest is charged and the entire $6 million is allocated to it, a 20-percent return on the manager's qualified capital interest. In total, the manager partner is allocated $8.8 million ($6 million plus $2.8 million). In this situation, it is not intended that all amounts allocated to the manager are recharacterized merely because the manager's interest is not charged a carry. Except as otherwise provided in Treasury regulations, the $6 million allocation to the service provider satisfies the allocation requirement that amounts be allocated in the same manner to service providers and to unrelated nonservice providers, because the difference in the rate of return (16 versus 20 percent) is attributable solely to the waiver of carry on the manager's qualified capital interest. The other $2.8 million allocated to the manager is recharacterized as ordinary income under the provision.

Definition of qualified capital interest

A qualified capital interest means the amount of a partner's interest in partnership capital attributable to (1) the fair market value of money or other property contributed by the partner to the partnership in exchange for the partnership interest (determined without regard to the deemed contribution rules of section 752(a), and without regard to any other deemed contribution), (2) the amount included in the partner's gross income under section 83 with respect to the transfer of the partnership interest by the partnership for services, and (3) the partner's distributive share of cumulative net income and gain of the partnership included in the partner's income, if any, that has not been distributed by the partnership. The qualified capital interest is reduced by partnership distributions to the partner, and by the partner's share of partnership losses, if any.

A qualified capital interest takes into account these amounts for taxable years prior to those to which the provision applies (as well as for years to which the provision applies). It is intended that an amount of prior-year qualified capital interest be documented by adequate contemporaneous records. For example, adequate contemporaneous records may include prior-year Schedule K-1s provided to the partner by the partnership, or other contemporaneous records that the Treasury Department in guidance provides are appropriate.

In the case of the transfer of an investment services partnership interest in a fully taxable transaction, the transferee partner accedes to the amount of the qualified capital account of the transferor partner. Unlike the basis rules of section 743 in the case of a transfer of a partnership interest, only the amount of the transferor's qualified capital interest is treated as the transferee's qualified capital interest. A qualified capital interest does not include any amount paid to a person other than the partnership; for example, such an interest does not include the price of a partnership interest acquired by purchase from another partner. It is intended that rules similar to the rules of section 197(f)(9) apply to the transfer of an investment services partnership interest.

To prevent double-counting of amounts as qualified capital interests when allocations are made with respect to contributed property under section 704(c), proper adjustments are required to be made to the amount of the qualified capital interest to take into account any difference resulting from the contribution of property to the partnership by a partner of property whose fair market value is not equal to its adjusted basis immediately before the contribution. For example, if the fair market value of the property is greater than the adjusted basis of the property immediately before the contribution, it is intended that adjustments reducing the qualified capital account are to be made in a manner similar to the adjustments made under 704(c) when appreciated property is contributed (a "forward" 704(c) transaction).

<u>Loans, advances, guarantees</u>

For purposes of the exception for qualified capital interests, an investment services partnership interest is not treated as acquired by contribution of capital to the extent of any loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership (or by a person related to that other partner or the partnership). For example, if partner A loans partner B funds that partner B contributes to the partnership, the loaned amount is not a qualified capital interest of partner B. An exception is provided for such loans repaid prior to the date of enactment.

In addition, any loan or other advance to the partnership made or guaranteed, directly or indirectly, by a partner not providing services to the partnership is treated as the qualified capital interest of that partner, for purposes of determining the amount of the service-providing partner's qualified capital interest, as well as for purposes of determining whether allocations to other partners' qualified capital interests are significant (but not, however, for purposes of determining whether allocations are made in the same manner to other partners' qualified capital interests as to the service provider's). Income and loss treated as allocable to qualified capital interests of partners are adjusted accordingly.

For example, if investor partners in a private equity fund that is a partnership contribute capital primarily as debt rather than as equity, while the manager of the fund contributes only equity so that his capital interest appears to be a large percentage of the total equity contributed, the provision treats the partnership debt to the investors as the investors' capital interests for this purpose. The percentage of total capital interests that is attributable to the fund manager in this example is determined taking into account this debt as well as the equity contributed to the fund, so the manager's capital interest is a smaller percentage of total capital interests than if only equity contributions were taken into account.

It is intended that an individual general partner's qualified capital interest take into account the value of certain property in the following specific circumstances. The individual general partner provides management services and holds an investment services partnership interest in a partnership. The partnership borrows on a fully recourse basis from an unrelated third party bank. The individual general partner unconditionally guarantees the loan, also on a fully recourse basis, and puts up his home as collateral for the loan. Later the partnership defaults on the debt and, pursuant to its terms, the bank forecloses on the home in satisfaction of the debt. In this situation, the fair market value of the foreclosed home at the time of foreclosure (up to the amount of the partnership debt satisfied in the foreclosure) is included in the general partner's qualified capital interest at the time that the debt is satisfied by foreclosure on the home.

Dispositions of investment services partnership interests

In general

On the disposition of an investment services partnership interest, gain (other than that attributable to the partner's qualified capital interest) is treated as ordinary income, notwithstanding the present-law rule that gain or loss from the disposition of a partnership interest generally is considered as capital gain or loss.[35] Gain on the disposition of an investment services partnership interest is recognized notwithstanding any other income tax provision, such as nonrecognition or deferral rules, except as otherwise specifically provided in the bill in the case of an electing partner in a contribution governed by section 721 of an investment services partnership interest to a partnership in exchange for an interest in that partnership or in the case of an electing partner in a contribution or deemed contribution of partnership property to which section 721 applies pursuant to a partnership termination, merger, consolidation, or division described in section 708(b)(1)(B) or (2).[36] Loss on the disposition of an investment services

[35] Sec. 741; except ordinary treatment applies to the extent gain is attributable to inventory and unrealized receivables under section 751(a). The bill adds investment services partnership interests to this category under section 751.

[36] The taxpayer must make an irrevocable election to treat the interest received in the section 721 exchange as an investment services partnership interest, and must comply with reporting and recordkeeping requirements as

partnership interest is treated as ordinary loss, but only to the extent of the amount by which aggregate amount previously treated as ordinary under the provision exceeds aggregate net loss previously treated as ordinary under the provision.

On the disposition of an investment services partnership interest, any portion of which is a qualified capital interest, new section 710(d)(6) provides that a proportionate amount of the gain or loss on disposition is not subject to the rule requiring recognition and treating the gain as ordinary. Under this rule, the proportionate amount of gain or loss not treated as ordinary is determined by the ratio of (1) the distributive share of gain or loss that would have been allocated to the qualified capital interest in a manner satisfying the allocation requirements of section 710(d)(1), had the partnership sold all its assets in a fully taxable transaction for cash in an amount equal to the fair market value of the assets immediately before the disposition, to (2) the distributive share of gain or loss that would have been so allocated to the investment services partnership interest of which the qualified capital interest is a part.

For example, a partner sells his investment services partnership interest for a gain of $100. A portion of the interest is a qualified capital interest (meeting the applicable definitional requirements), allocations are made to the qualified capital interest in the same manner as they are made to qualified capital interests of unrelated nonservice providing partners, and those allocations are significant compared to the allocations made to the disposing partner's qualified capital interest, so that the allocation requirements of section 710(d)(1) are met. If the partnership were to sell all its property in a fully taxable transaction for cash in an amount equal to the fair market value of the property immediately before the disposition of the investment services partnership interest, gain allocable to the selling partner's qualified capital interest would be $80, and gain allocable to the selling partner's entire investment services partnership interest would be $400, a ratio of 20 percent. Thus, the proportionate amount of the $100 gain that is not subject to recharacterization as ordinary income is $20.

Dispositions by gift or by death

On the disposition of an investment services partnership interest by gift or by reason of the death of the taxpayer, the rule requiring gain to be recognized and treated as ordinary does not apply. The partnership interest is treated as an investment services partnership interest in the hands of the person acquiring the partnership interest.

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required by the Treasury Department. Under this rule, the partnership interest received in the exchange thereafter gives rise to income, gain, and loss subject to the rules of the provision as if the taxpayer were providing the investment management services with respect to assets of the partnership, and the amount of the transferor's qualified capital interest (if any) is treated as the transferee's qualified capital interest. It is not intended that built-in gain or loss, if any, with respect to the interest surrendered in the exchange be locked in or fixed at the time of the exchange, but rather, that the interest received in the exchange be treated as an investment services partnership interest in all respects. Thus, for example, the contribution of an investment services partnership interest to another partnership in exchange for an interest in that partnership (for example, the contribution of partnership interests to an operating partnership of an UPREIT or a partnership rollup) remains a nonrecognition transaction governed by section 721 if this election is made, provided that section 721 otherwise applies to the transaction.

In the case of death, the amount that would have been treated as ordinary income under the provision upon the sale of the investment services partnership interest by the decedent immediately before death is treated as an item of income in respect of a decedent under section 691. It is intended that this income retains the character provided under section 710, so it is treated as ordinary to the same extent as under the rules of section 710.[37] No stepup in basis at death under section 1014 is allowed with respect to an investment services partnership interest of a decedent, as it constitutes a right to receive an item of income in respect of a decedent.[38]

Indirect disposition of an investment services partnership interest under section 751

In the case of the disposition of an interest in a partnership that itself holds any investment services partnership interests, the amount of money, or the fair market value of property, received by the transferor partner in exchange for all or a part of his interest in the partnership attributable to investment services partnership interests held by the partnership is considered as an amount realized from the sale or exchange of property other than a capital asset. Thus, this amount is taxed as ordinary income and is recognized notwithstanding any other provision.

Under the rules of section 751 for tiered partnerships, in determining whether property of a partnership is an investment services partnership interest, the partnership is treated as owning its proportionate share of the property of any other partnership in which it is a partner, but not to the extent an interest is itself an investment services partnership interest. The partnership is treated as owning its proportionate share of the property attributable to that part of an investment services partnership interest that is a qualified capital interest (i.e., a qualified capital interest is treated like any other partnership interest for purposes of this tiered partnership rule). In an exchange of a publicly traded partnership interest, investment services partnership interests are not taken into account for purposes of the rules of section 751 relating to ordinary income treatment on an exchange of a partnership interest, a distribution of partnership property, or certain tiered partnerships.[39]

The Treasury Department is directed to provide prompt guidance with respect to acceptable methods for valuing an investment services partnership interest for purposes of section 751. Acceptable methods do not include any valuation method that is inconsistent with the valuation method used by the taxpayer (or the partnership whose interest is being disposed of) for purposes of reporting asset values to current or potential investors in the partnership (or a related partnership), if the valuation method would result in a lesser value than under the valuation method used for reporting asset values to current or potential investor partners.

[37] See sec. 691(a)(3).

[38] Sec. 1014(c).

[39] Specifically, secs. 751(a)(3), 751(b)(1)(A)(iii), and 751(f)(3), as provided by the bill.

Treatment of enterprise value

As under present law, if a partner in a partnership disposes of his partnership interest at a gain, an amount paid in excess of the fair market value of the assets of the partnership may be characterized as capital gain.[40] Such excess amount is commonly referred to as attributable to goodwill, or enterprise value, of the partnership.

Under the bill, income and gain attributable to an investment services partnership interest is characterized as ordinary income. Consistent with the policy of section 751, the bill treats the acceleration (through a disposition) of income and gain which would be characterized as ordinary income under the provision as ordinary. The bill does, however, preserve the present law treatment of enterprise value upon the disposition of an interest in a partnership that is not an investment partnership.

Example

For example, assume that a partnership (the "Management Partnership") is owned by five individuals, all of whom hold their interests in connection with the conduct of the trade or business of advising as to the advisability of investing in, purchasing, or selling specified assets held indirectly by the Management Partnership. The sole source of capital for the Management Partnership is cash contributed directly by the partners on an after-tax basis; thus, all of the capital of the Management Partnership is attributable to qualified capital interests of the partners. The Management Partnership does not satisfy either of the two requirements for being an investment partnership within the meaning of new section 710. Assume also that the Management Partnership holds (1) interests in three investment partnerships and (2) a building used as the partnership's offices that is not held for rental or investment. One partner in the Management Partnership sells his interest in the Management Partnership, realizing a gain. Section 751, as amended by the bill, provides that the portion of the selling partner's gain attributable to the Management Partnership's investment services partnership interests (including the value of any accrued but unpaid carry and the expectation of future carry with respect to those interests) is treated as ordinary income. Provided section 741 otherwise applies, the balance of the gain (i.e., the portion attributable to the value of the building and/or any goodwill or going concern value of the Management Partnership) is treated as capital gain.

Partnership distributions

In general

In the case of a distribution of property by a partnership to a partner with respect to an investment services partnership interest, the partner recognizes gain to the extent the fair market value of the property exceeds his basis in the distributed property determined without regard to this provision. The gain recognized by the partner is treated as ordinary income to the same extent and in the same manner as the increase in the partner's distributive share of partnership taxable income would be treated under the general rule of the provision recharacterizing net

[40] Sec. 741.

capital gain as ordinary, if, immediately prior to the distribution, the partnership had sold the distributed property at fair market value and all of the gain were allocated to the partner. For purposes of applying the limitation on the recharacterization of losses under section 710(a), gain from the distribution of property treated as ordinary income is treated as recharacterized under the rule for a partner's distributive share of partnership items. The basis of the distributed property in the hands of the distributee partner is the fair market value of the property.

For example, assume a partnership holds property which is not itself a partnership interest. The partnership's adjusted basis in the property is $20 and the property's fair market value is $50. The partnership distributes the property to a partner whose investment services partnership interest has an adjusted basis of $10. Under the provision, the amount of gain that that the distributee partner is required to recognize on the distribution is $40 ($50 minus $10, the partner's adjusted basis in the distributed property determined under section 732(a)(2) without regard to this provision). The distributee partner's basis in the distributed property under the provision is $50 (its fair market value at the time of distribution). The distributee partner's basis in his partnership interest is reduced to zero (sec. 733). The portion of the $40 gain required to be recognized that is ordinary is determined as if the partnership had sold the distributed property at fair market value and all of the gain were allocated to the partner.

In the case of a distribution of a partnership interest in connection with the contribution (or deemed contribution) of property to a partnership to which section 721 applies pursuant to a partnership termination, merger, consolidation, or division described in section 708(b)(1)(B) or (2), however, the rule treating a distribution of partnership property as a recognition event does not apply, if the partner elects to treat the partnership interest received as an investment services partnership interest and complies with reporting and recordkeeping requirements mandated by the Treasury Department.

<u>Distribution of investment services partnership interest subject to section 751</u>

To the extent a partner receives in a partnership distribution property that is an investment services partnership interest, then the transaction is considered as a sale or exchange of the investment services partnership interest between the distributee and the partnership (as constituted after the distribution). Thus, the distribution can give rise to ordinary income.

Other entities

The provision recharacterizes as ordinary income the income or gain with respect to certain other interests, including interests in entities that are held by a person who performs, directly or indirectly, investment management services for the entity.

This rule applies if (1) a person performs (directly or indirectly) investment management services for any entity which, if it were a partnership, would be an investment partnership, (2) the person holds a disqualified interest with respect to the entity, and (3) the value of the interest (or payments thereunder) is substantially related to the amount of realized or unrealized income or gain from the assets with respect to which the investment management services are performed. In this case, any income or gain with respect to the interest is treated as ordinary income. Rules similar to the rules governing treatment of dividends as not eligible to be qualified dividends taxed at capital gains rates, and similar to the rules providing an exception for a partner's qualified capital interest, apply for this purpose. For this purpose, a disqualified interest with respect to an entity means (1) any interest other than debt, (2) convertible or contingent debt, (3) an option or other right to acquire either of the foregoing, or (4) a derivative instrument entered into (directly or indirectly) with the entity or an investor in the entity. A disqualified interest does not include a partnership interest. However, an option to acquire a partnership interest may be a disqualified interest. A disqualified interest also does not include, except as provided otherwise in Treasury regulations or guidance, stock in an S corporation or stock in a taxable corporation, which for this purpose means either a domestic C corporation or a foreign corporation, substantially all of the income of which is effectively connected with the conduct of a trade or business in the United States, or that is subject to a comprehensive foreign income tax. It is not intended that the exception for stock in an S corporation or domestic C corporation permit avoidance of the general rule relating to partnership interests through establishment of economically similar arrangements. Under this rule, a comprehensive income tax means the income tax of a foreign country if the foreign corporation is eligible for the benefits of a comprehensive income tax treaty between that country and the United States, or if the corporation demonstrates to the satisfaction of the Treasury Secretary that the foreign country has a comprehensive income tax.

For example, if a hedge fund manager holds stock of a Cayman Islands corporation that in turn is a partner in a hedge fund partnership, the manager performs investment management services for the hedge fund, and the value of the stock (or dividends) is substantially related to the growth and income in hedge fund assets for which the manager provides investment management services, then gain in the value of the stock, and dividends, are treated as ordinary income. The fact that the services are performed for the hedge fund, rather than directly for the Cayman Islands corporation in which the manager has a disqualified interest, does not change this result under the provision. Thus, the gain is not eligible for the capital gain tax rate but rather, both the gain and the dividend are subject to tax as ordinary income. The income is treated as net earnings from self-employment for purposes of the self-employment tax of the individual who performs the services. Though the amounts received may exceed the cap (imposed by reason of section 1402(b)) on the old-age, survivors, and disability insurance portion of the self-employment tax, the hospital insurance portion of the self-employment tax is not capped, and applies to the income.

Underpayment penalty

The provision provides that the accuracy-related penalty under section 6662 on underpayments applies to underpayments attributable to the failure to comply with section 710(e) (relating to the treatment of income in connection with investment management services involving disqualified interests), the regulations under section 710(f) (other regulatory authority) to prevent the avoidance of the purposes of section 710. The penalty rate is 40 percent. A strengthened reasonable cause exception similar to that applicable to reportable transaction understatements may apply with respect to the section 710(e) or (f) underpayments. The strengthened reasonable cause exception does not apply unless (1) the relevant facts affecting the tax treatment of the item are adequately disclosed, (2) there is or was substantial authority for the tax treatment, and (3) the taxpayer reasonably believed that the tax treatment was more likely than not the proper treatment. Rules similar to the rules of section 6664(d)(3) apply for purposes of determining reasonable belief.

Self-employment tax and Medicare unearned income tax

In general

Under the provision, in the case of any individual who is engaged in the trade or business of performing the services described in new section 710(c)(2) with respect to any entity, investment services partnership income or loss (as defined for purposes of this rule) is taken into account in determining the individual's self-employment tax. It is intended that an entity include a partnership as well as an entity described in section 710(e) or guidance thereunder. Investment services partnership income or loss is defined for this purpose to mean, with respect to any investment services partnership interest or disqualified interest (within the meaning of new section 710(e)), the net of (1) amounts treated as ordinary income or ordinary loss by reason of a disposition of, or distribution with respect to, an investment services partnership interest under new section 710(b) or by reason of being other income or gain in connection with a disqualified interest under new section 710(e), (2) all items of income, gain, loss, and deduction allocated to the investment services partnership interest, and (3) the amounts treated as ordinary under section 751 with respect to the investment services partnership interest. Because gain from the disposition of an investment services partnership (other than a qualified capital interest) is treated as ordinary income, the present-law exception under the self-employment tax rules for gain or loss from the sale or exchange of a capital asset does not apply. The provision applies notwithstanding the present-law exclusion for limited partners under the self-employment tax.[41] Thus, the present-law exclusion for limited partners under the self-employment tax does not apply to investment services partnership income or loss.

As provided under present law, for purposes of the Medicare unearned income tax,[42] in the case of a partnership holding assets for investment, each partner's distributive share of items of income, gain, or loss taken into account under section 702 is taken into account in determining the net investment income of the individual partner regardless of whether the partner is in the trade or business of providing the services specified in new section 710(c)(2) with respect to assets held (directly or indirectly) by the partnership. Thus, for example, assume that an individual provides investment management services. The individual holds an investment services partnership interest in a partnership that, in turn, holds a partnership interest in, and serves as the manager of the investments of, a private equity fund partnership. The individual partner's distributive share of the fund's interest, dividends, annuities, royalties, rents, and gains is taken into account in determining his or her Medicare unearned income tax. Items that are

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[41] Sec. 1402(a)(13).

[42] Section 1411; net investment income for this purpose is defined in section 1411(c). Section 1411 is effective for remuneration received, and taxable years beginning after, December 31, 2012.

subject to the SECA tax by reason of this provision are not subject to the Medicare unearned income tax.

To the same extent as under present law, the provision does not permit net operating loss deductions in calculating net earnings from self-employment.[43]

<u>Rules relating to publicly traded partnerships</u>

The provision provides that specified carried interest income is not qualifying income of a publicly traded partnership for taxable years beginning on or after the date that is 10 years after the date of enactment.

Specified carried interest income of a publicly traded partnership means (1) any item of income or gain allocated to an investment services partnership interest held by the publicly traded partnership, (2) any gain on the disposition of either an investment services partnership interest or a partnership interest to which (in the hands of the publicly traded partnership) section 751 applies, and (3) any income or gain taking into account by the publicly traded partnership by reason of a distribution with respect to an investment services partnership interest under new section 710(b)(4) or by reason of the rule governing other income or gain in connection with investment management services under new section 710(e). An exception is provided for amounts allocable to a qualified capital interest similar to the rule of new section 710(d).

Thus, for example, for such a taxable year, if a publicly traded partnership holds an investment services partnership interest (and the exception for qualified capital interest does not apply to any part of it), the publicly traded partnership's income and gain from that investment services partnership interest is not qualifying income for purposes of section 7704. A publicly traded partnership, more than 10 percent of whose gross income consists of income from an investment services partnership interest, is treated as a corporation for Federal tax purposes under section 7704.[44]

The rule that items of income and gain that are ordinary income by reason of new section 710 are not qualifying income does not apply, however, in the case of qualifying income under section 7704(d)(1)(E) and so much of 7704(d)(1)(F) as relates to 7704(d)(1)(E). Thus, income and gains from exploration and other activities relating to oil, gas, other natural resources, and other items so described are not treated as other than qualifying income by reason of being recharacterized as ordinary income.

The provision provides a special rule for certain partnerships that are owned by publicly traded REITs and that meet specific requirements. Under this special rule, the rule that specified carried interest income is not qualifying income of a publicly traded partnership does not apply,

[43] Sec. 1402(a)(4).

[44] The present-law exception to corporate treatment for a publicly traded partnership, 90 percent or more of whose gross income is qualifying income within the meaning of section 7704(c)(2), does not apply in such a case, because under the provision, net income from an investment services partnership interest is not qualifying income within the meaning of section 7704(c)(2).

if: (1) the partnership is treated as publicly traded (under section 7704) solely because interests in the partnership are convertible into interests in a publicly traded REIT; (2) 50 percent or more of the capital and profits interests of the partnership are owned, directly or indirectly, at all times during the taxable year, by the REIT (taking into account attribution rules under section 267(c)); and (3) the partnership itself satisfies the REIT income and asset limitations under sections 856(c)(2), (3), and (4). Thus, for example, the exception from the rule treating specified carried interest income as other than qualifying income of a publicly traded partnership applies in an UPREIT structure in which a publicly traded REIT owns more than 50 percent of the capital and profits interests of the partnership, partnership interests held by persons other than the REIT are convertible into publicly traded REIT stock, and the partnership itself meets the income and asset limitations of the REIT rules under sections 856(c)(2), (3), and (4). For this purpose, if the partnership interest may be put to the REIT or the partnership for REIT stock, it is considered convertible into interests of the publicly traded REIT. It is not intended that convertibility of partnership interests into a class of publicly traded REIT stock that tracks the performance of particular partnership assets (such as assets of a type that, if held in excess, would cause the REIT asset or income limitations not to be satisfied), or performance of the partnership assets generally, satisfies this special rule; rather, it is intended that such a partnership does not meet the requirements of this special rule.

The provision provides a special rule for partnerships owning certain other publicly traded partnerships (i.e., exchange-traded partnerships whose income is ordinary). Under this special rule, the rule that specified carried interest income is not qualifying income of a publicly traded partnership does not apply in the case of a partnership that meets two requirements: (1) substantially all of the partnership's assets are interests in other partnerships that are traded on an established securities market; and (2) substantially all of the partnership's income is ordinary income or section 1231 gain. For this purpose, partnership interests that are readily tradable on a secondary market (or the substantial equivalent thereof) do not qualify; only those that are traded on an established securities market (for example, the New York Stock Exchange) meet the requirement of this special rule. It is intended that a substantial portion of the equity of the partnership be so traded; for example, if less than a substantial portion of the interests of the partnership are traded on an established securities market, the requirement is not satisfied.

Regulatory authority

The Treasury Department is directed to prescribe such guidance as is necessary or appropriate to carry out the purposes of new section 710, including guidance to provide modifications to the application of the provision (including treating related persons as not related to one another) to the extent such modification is consistent with the purposes of this section, to prevent the avoidance of the purposes of the provision, and to coordinate the provision with other provisions of Federal tax law. It is intended that Treasury guidance prescribe such reporting and recordkeeping requirements as are necessary to carry out the provision.

It is expected that guidance and regulations will, among other things, address the effects, if any, of the provision on whether income is U.S. or foreign source (or is sourced within a U.S. possession); how income is characterized for purposes of the foreign tax credit limitation rules; whether income is subject to tax by the United States by reason of sections 897 and 1445 (sale of U.S. real property) or is exempt from U.S. tax under section 892 (income of foreign governments); whether income is effectively connected with the conduct of a trade or business within the United States; and whether income is subject to current U.S. tax under the passive foreign investment company or subpart F rules.

The intent of the provision is generally not to change the result under these rules, to the extent that is consistent with not providing an opportunity to avoid the recharacterization of income as ordinary under the provision and not creating an opportunity for exclusion or deferral of otherwise includable amounts. Thus, in general, it is not intended that the recharacterization of items of income or loss as ordinary under the provision effect a change in the source of the items or cause the items to be treated as effectively connected with the conduct of a U.S. trade or business, if the items would not otherwise be so treated. This intent is to be carried out consistently with the purposes of the provision. For example, it is not intended that the provision be utilized to effect a recharacterization as untaxed foreign-source ordinary income from personal services the amount of any otherwise taxable (or witholdable) U.S.-source dividend, effectively connected income, U.S. real property gain, or similar income or of any otherwise taxable subpart F inclusion or passive foreign investment company inclusion.

It is not intended that solely the recharacterization of income as ordinary under the provision cause income of a REIT that otherwise meets the requirements of section 856(c)(2), (3), or (4) to fail to meet the requirements of those paragraphs. Likewise, it is not intended that solely the recharacterization of income as ordinary under the provision cause income of a regulated investment company ("RIC") that otherwise meets the requirements of section 851(b) to fail to meet the requirements of that subsection.[45] Similarly, it is not intended that solely the recharacterization of income as ordinary under the provision cause income not otherwise treated as unrelated business income of an exempt organization to fail to meet provisions of section 512(b) that are otherwise satisfied.

It is not intended that income or loss characterized as ordinary under the provision be taken into account in determining net investment income for purposes of the investment interest limitation of section 163(d).

It is not intended that opportunities to avoid or defer income inclusion be created by the recharacterization of income or loss as ordinary under the provision.

It is not intended that that provision affect the ability of taxpayers to rely on guidance with respect to sections 409A and 457A as such guidance applies to a profits interest in a partnership, that is, guidance permitting taxpayers to treat the issuance of a partnership interest

[45] For example, capital gain of a RIC that is a business development company that is recharacterized as ordinary under the provision is not intended to fail to qualify under section 851(b) solely by reason of recharacterization under this provision. No inference is intended that a RIC (such as a RIC that is not a business development company) may engage in the activities that give rise to income or gain recharacterized as ordinary under the provision.

(including a profits interest), or an option to purchase a partnership interest, granted in connection with the performance of services, as not resulting in the deferral of compensation.[46]

Effective Date

The provision relating to transfers of partnership interests under section 83 is effective for partnership interests transferred after the date of enactment.

The provision relating to net capital gain with respect to an investment services partnership interest treated as ordinary income is effective generally for taxable years ending after the date of enactment.

In the case of a partnership taxable year that includes the date of enactment, the amount of net capital gain determined for purposes of the general rule of the provision treating it as ordinary (section 710(a)) is treated as being the lesser of the net capital gain for the entire partnership taxable year or the net capital gain determined by taking into account only items attributable to the portion of the partnership taxable year that is after the date of enactment.

The provisions relating to dispositions of partnership interests and distributions of partnership property apply to dispositions and distributions after the date of enactment. The provision relating to indirect dispositions under section 751 applies to transactions after the date of enactment.

The provision relating to other income and gain is effective on the date of enactment.

The rule that income from an investment services partnership interest is not qualifying income of a publicly traded partnership under section 7704 applies to taxable years of the partnership beginning on or after the date that is 10 years after the date of enactment.

[46] Preamble to Treas. Reg. 1.409A, T.D. 9321, April 17, 2007, and IRS Notice 2005-1, Q&A 7 and IRS notice 2009-8, Q&A 2.